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Selling Roads Proves Last Resort as Taxes Dwindle

By Adam L. Cataldo

Jan. 24 (Bloomberg) -- The widening budget deficits across the U.S. are forcing California, New York and other big states to consider the once unthinkable decision to sell their roads and lotteries for cash that no one wants to raise with new taxes.

Vermont Governor James Douglas and New York Governor Eliot Spitzer said they want to lease their lotteries to pay for education, while South Carolina's Mark Sanford said he may sell or lease toll rights to private buyers. In California, where the \$14 billion budget shortfall is the nation's biggest, Arnold Schwarzenegger plans to shed the state's student loan agency.

With tax collections rising at a slower pace than inflation for the first time since 2003, state officials may ``yield to the temptation to take the money and run," said Joseph M. Giglio, a professor at Northeastern University's business school in Boston. That's good news for pension funds and banks including Goldman Sachs Group Inc. and Citigroup Inc., which have had little chance in the U.S. to deploy the almost \$31 billion they're amassing for public infrastructure and related investments the last two years, data compiled by Bloomberg show.

``If you look at the need for money, it becomes more and more pronounced almost on a daily basis," said Dana Levenson, who negotiated the lease of Chicago's Skyway toll road and parking system when he was the city's chief financial officer in 2005 and 2006.

Fewer Choices

The prospect of a recession leaves fewer choices for state politicians who had been reluctant to relinquish control of their operations last year, said Giglio, a former banker at Smith Barney Inc. who wrote two books on funding transportation. The Federal Reserve on Jan. 22 cut its benchmark interest rate by 0.75 percentage point to 3.5 percent, amid increasing signs of a slowdown.

U.S. state tax revenue fell 0.6 percent in the third quarter after adjusting for tax law changes and inflation, the first decline since the third quarter of 2003, according to a report released last week by the Nelson A. Rockefeller Institute of Government in Albany, New York.

“An awful lot of public sector entities are looking at all of the options and all of the options include private sector involvement,” said Felicity Gates, co-head of Citigroup's Citi Infrastructure Investors. “Some people previously may have said, ‘Look, politically that won't fly, let's put it to one side.’ Now people are saying, ‘Dust it off.’”

Mounting Shortfalls

Twenty-one states face budget deficits in fiscal 2009, including 16 that are short at least a combined \$30 billion, according to the Washington-based Center on Budget and Policy Priorities. Governments need to spend \$1.6 trillion over five years to bring infrastructure into “good” condition, according to 2005 estimates from the American Society of Civil Engineers.

“There is a great, great need to find new revenue to support budgets and also the capital investments states need to make,” said Mark B. Florian, managing director in the Public Sector and Infrastructure Banking Group at Goldman Sachs Group Inc.

Florian worked on the two largest transactions involving public toll roads in U.S. history, and is a member of the National Surface Transportation Infrastructure Financing Commission. That group was set up by the U.S. Congress to study ways to pay for capital spending.

“There are always needs,” Florian said, “but there is a particular need today given the economy slowing plus this capital budget need.”

Road Revenue

One way to plug the gap is to seek private investors. By selling or leasing assets, states get the upfront payments they need and buyers get the rights to collect the revenue from the operations. Ultimately, the investors expect they'll bring in more than they paid.

The 5,200 miles (8,360 kilometers) of publicly owned toll roads, bridges and tunnels in the U.S. generated about \$7.4 billion in revenue in 2006, said Neil Gray, director of government affairs for the International Bridge, Tunnel and Turnpike Association in Washington. Chicago and Indiana leased highways in 2005 and 2006 for a combined \$5.6 billion, the two largest privatizations of toll roads in U.S.

Private-equity and pension funds like infrastructure investments because they're a steady source of income even in a slowing economy, said William Atwood, executive director of the Illinois State Board of Investment in Chicago. The board plans to devote \$600 million to such projects over the next two years.

‘Foreclosing’ on Future

“Politicians want benefits now and costs later, and they are typically not very thoughtful in how they finance infrastructure assets,” Giglio said. “The problem is that these assets

have a useful life of 50, 75, 100 years if you maintain them, but the election cycle is four years."

Governments that agree to the long-term sale or lease of assets to private companies ``are foreclosing on their future financial flexibility," said David Stall, city manager of Shoreacres, Texas, a suburb of Houston.

Stall helped form a grassroots group in Texas in 2004 to oppose a toll road. Their efforts led lawmakers to pass a measure in June imposing limits on privately operated toll roads for a two-year period. And in South Carolina, the Legislature blocked previous efforts to sell golf courses and a power plant.

Investors hit a ``bump in the road" last year, but ``all that has changed," said Levenson, now a managing director in Royal Bank of Scotland Group Plc's North American infrastructure finance and advisory unit.

Infrastructure Funds

The beneficiaries may include New York-based Goldman, the world's largest securities firm, and competitors Citigroup and Morgan Stanley. Goldman raised \$6.5 billion to invest in infrastructure in the U.S., Canada and Europe, while Citigroup and Morgan Stanley, also in New York, are each assembling \$3 billion for their infrastructure funds.

The nation's 44 state lotteries had cumulative sales of \$57.4 billion in fiscal 2006, according to the North American Association of State and Provincial Lotteries.

In Vermont, Douglas, a Republican, wants to lease the lottery to a private company to raise money for schools and enable property-tax reductions. The new operator would pay the state \$56 million upfront and \$23 million a year for 40 years, according to New York-based Lehman Brothers Holdings Inc., the investment bank Douglas hired to analyze the plan.

``We're hoping this will help us avoid the fiscal storms that are plaguing other states," Michael Smith, Douglas's administration secretary, said in an interview last week. Vermont isn't facing a budget shortfall.

Spitzer's Plan

In New York, where lottery profits of about \$2.2 billion are the highest in the nation, Spitzer's proposal to sell or lease part of the system has yet to be approved by lawmakers. The Democratic governor would create an endowment for the State University of New York and City University of New York, providing funding that won't be part of the state's normal appropriations.

``Our first consideration was to protect the state from the downside of the lottery business," said Paul Francis, director of state operations, in an interview this month.

A lease would shield the state's coffers should customers migrate to casinos and lotteries in nearby states, he said. New York faces a \$4.4 billion deficit for the 12 months beginning April 1.

California Proposals

Schwarzenegger, a Republican, plans to sell the student loan agency, California EdFund, and earlier this month proposed that private companies build and maintain roads. The EdFund sale may raise as much as \$500 million, he said.

South Carolina is considering private-sector investment in its transportation system following changes in state law that gave the governor more of a say, Sanford said. While money dedicated for transportation is growing and the state in recent years has tapped its general fund budget to pay for projects, it isn't enough, Sanford, a Republican, said in an interview.

“The reality is that there are growing and pressing road needs in our state and consequently that need is going to drive a political debate,” he said.

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